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Supreme Court, U. S.
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1980

NEW YORK WATER SERVICE CORP.,

Petitioner,

v.

PUBLIC SERVICE COMMISSION OF THE STATE OF NEW YORK,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE NEW YORK COURT OF APPEALS

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June 30, 1980

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IN THE

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October Term, 1980

NEW YORK WATER SERVICE CORP.,

Petitioner,

v.

PUBLIC SERVICE COMMISSION OF THE STATE OF NEW YORK,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE NEW YORK COURT OF APPEALS

The petitioner, New York Water Service Corp., respectfully prays that a writ of certiorari issue to review the order of the New York Court of Appeals entered April 1, 1980, denying leave to appeal from an order of the Appellate Division of the New York Supreme Court (Third Judicial Department) entered November 20, 1979.

Opinion Below

The opinion of the Appellate Division of the Supreme Court, Third Judicial Department is reported at 72 A.D.2d 841 (1979) and appears as Appendix A to this petition. The opinion and order of the New York Public Service Commission ("NYPSC"), which was affirmed by the Appellate Division, will be reported at 18 N.Y.P.S.C. —— and appears as Appendix B to this petition. The NYPSC's order denying the petition for reconsideration appears as Appendix C to this petition.

Jurisdiction

The order of the New York Court of Appeals denying the petitioner's motion for leave to appeal was entered on April 1, 1980. This petition for certiorari is filed within 90 days of that date. This Court's jurisdiction is invoked under 28 U.S.C. § 1257(3), on the ground that a right, title, privilege or immunity is set up and claimed under the Fourteenth Amendment to the United States Constitution.

Question Presented for Review

Should *FPC* v. *United Gas Pipeline Co.*, 386 U.S. 237 (1967), be overruled or limited because it failed to recognize that a state, through its regulatory commission, confiscates a valuable asset of a corporation, in violation of the due process clause, when it reaches through a regulated entity to deprive its unregulated parent of the right to use its tax loss as an offset in a consolidated return?

Constitutional Provision Involved

Fourteenth Amendment, United States Constitution:

> No State shall . . . deprive any person of . . . property, without due process of law.

Statement of the Case

Petitioner, New York Water Service Corporation (NYWS), is a regulated public utility providing water to some 43,000 customers in the Merrick/Massapequa area of Nassau County, New York. NYWS is a wholly-owned subsidiary of Utilities and Industries Corp. (U&I), a non-

regulated entity which also has a number of other subsidiaries engaged in diverse businesses.*

NYWS's business is profitable, and it is undisputed that if NYWS were an independent entity, it would have substantial liability for federal income taxes. U&I, however, has reported substantial losses on its income tax returns for several years. In order to get the full tax benefit resulting from these losses, U&I files a consolidated tax return with NYWS, so that U&I's losses are applied against NYWS's income. In recent years, the consolidated returns have shown a net loss; if these returns are not disturbed on audit by the Internal Revenue Service, the consolidated entity will pay no taxes for those years.

In 1975, in connection with a tariff application by NYWS, the PSC concluded that if NYWS filed a separate federal income tax return and if it earned the income which the PSC held it to earn, it would have an annual federal income tax liability of approximately $630,000. The rates which NYWS was allowed to charge its customers were designed to cover this projected tax liability. This 1975 decision, consistent with prior New York law as reflected in *Citizens Water Supply Company of Newtown,* 14 NY PSC 1353 (1974), effectively treated NYWS as though it stood alone for tax purposes, permitting U&I to retain the benefit resulting from its tax loss.

Subsequent to this decision, the PSC reversed itself. It *sua sponte* directed NYWS to segregate the $630,000 pending further information as to the actual tax payments made by NYWS and its parent, U&I, pursuant to the consolidated

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* NYWS is itself an indirect subsidiary of U&I, and some of the other corporations in the consolidated group are direct or indirect subsidiaries of NYWS. For convenience, we refer in this petition to U&I and all its other direct and indirect subsidiaries collectively as "U&I," or as the "parent" of NYWS.

federal income tax return they filed. Thereafter, in orders dated September 22 and November 27, 1978, the PSC concluded that because little or no federal income taxes were in fact paid by the consolidated entity—notwithstanding the profitable operations of NYWS—due to net operating tax loss carry-forwards of U&I, the money set aside for NYWS's tax liabilities should be refunded utility's customers. (Appendices B and C) The PSC ordered a refund to NYWS's customers totalling $630,000, and directed that $1,867,000 be placed in an escrow fund. These orders were affirmed by the Appellate Division (Appendix A), and the New York Court of Appeals denied leave to appeal (Appendix D).

Thus, the issue in this proceeding is whether the tax benefits resulting from U&I's losses may be retained by U&I—which would occur if NYWS were permitted, in calculating its rates, to take into account the federal income taxes that it would have paid as an independent entity. The New York courts have decided that U&I's tax benefits should be used to reduce the water rates of NYWS's customers. This amounts to confiscation of a valuable asset of U&I by the State of New York.

Reason compels the conclusion that the benefit of the tax losses belongs to U&I. The purpose of Congress in permitting corporations to offset past and present losses against gains was to provide tax relief to corporations, like U&I, that lose money. It would obviously be irrational to make NYWS's customers subsidize U&I's losses; and it is just as irrational to make U&I subsidize NYWS's customers, by turning over to them the tax benefit which U&L's losses generate. To put it another way, there is no reason whatever why the citizens of Merrick/Massapequa should pay lower water rates because NYWS's parent loses money—or higher water rates if their water company's parent happens to become profitable.

The federal question sought to be reviewed in this case—whether the confiscation of a corporation's right to use a tax loss as an offset constitutes a deprivation of property without due process in violation of the Fourteenth Amendment—was first raised in petitioner's brief to the Supreme Court, County of Albany. When, pursuant to NYCPLR § 7804(g), this proceeding was transferred to the Appellate Division, Third Department, petitioner again raised this federal question in its brief. Petitioner attempted to appeal as of right to the New York Court of Appeals and raised the federal question in its jurisdictional statement. The appeal as of right was dismissed, and petitioner again raised the federal issue in its motion for leave to appeal, which was denied by the April 1 order of which petitioner now seeks review.

Reasons for Granting the Writ

The Supreme Court decision in *FPC* v. *United Gas Pipeline Co.*, 386 U.S. 237 (1967) is contrary to the United States Constitution, and should be overruled or limited to its narrow statutory holding. In the 13 years since that case was decided, it has provided authority for a large number of ratemaking proceedings which have served unconscionably to deprive utilities of their property without due process of law.* The decision below provides an egregious example.

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* *See, United Inter-Mountain Telephone Company* v. *Public Service Commission*, 555 S.W.2d 389, 393 (1977); *Mountain States Telephone and Telegraph Company* v. *Public Utilities Commission*, 576 P.2d 544, 550 (1978); *Long Island Water Corporation* v. *Public Service Commission*, 49 A.D.2d 392, 394, 374 N.Y.S.2d 841, 843 (1975); *Lambertville Water Company* v. *New Jersey Board of Public Utility Commissioners*, 378 A.2d 1158, 1160 (1977); *Monarch Gas Company* v. *Illinois Commerce Commission*, 366 N.E.2d 945, 948-49 (1977); *Florida Gas Transmission Company*, 47 F.P.C. 341, 361-2 (1972); *Alabama Power Company*, 45 F.P.C. 1068, 1096, n. 27, (1971); *Northwestern Bell Tel. Co.* v. *State*, 253 N.W.2d 815, 821 (1977); *Mechanic Falls Water Company* v. *Public Utilities Commission*, 381 A.2d 1080, 1094 (1977).

In *United Gas,* the utility in question, a gas company, also participated in a consolidated return which had the effect of reducing its actual tax expenditures. United argued, as the NYWS has argued in these proceedings, that in determining the cost of service it should be treated as if it filed its tax returns as a separate entity. The Federal Power Commission applied a formula for allocating the consolidated tax paid among regulated companies—where losses of unregulated companies reduced the tax expenditures of regulated companies—in proportion to their taxable income. This Court, by a vote of 6-3, held the application of this formula to be consistent with the Natural Gas Act. What the Court failed to recognize is that to the extent that this allocation reduced the gas company's rates from what it would have been allowed to charge as a separate entity, the FPC was confiscating the tax loss of the unregulated group. The Court demonstrated its error by stating that the losses "remain with the system, readily available to reduce the taxes of the profitable affiliate to the maximum extent allowed by the tax law." *United Gas, supra,* at 247. As the dissent pointed out, "[T]his hypothetical 'availability' is meaningless for the 'instant cash' produced by the losses is passed on to the ratepayers rather than, as the tax laws intend, to the loss corporations. The fact that the group's tax payment is lower will not satisfy the intent behind the reserve provisions which was not to reduce government collections but to increase resources available to the business unit." *United Gas, supra,* at 256 (dissenting opinion).

A tax loss is an asset. To a corporation like U&I, a tax loss is a valuable asset. Confiscation of this asset deprives a corporation of its property without due process of law.

In the *Western Pacific Railroad Case,* 345 U.S. 247 (1953), Mr. Justice Jackson explained why a tax loss is a legitimate asset to a corporation like U&I.

In *Western Pacific,* a parent corporation and certain of its stockholders sought an accounting from former subsidiaries on the theory that the subsidiaries had unjustly enriched themselves by appropriating tax losses of the parent. The majority remanded the case on a purely procedural point, but Justice Jackson discussed the merits in his dissent. He said:

> "It may seem anomalous at first glance that a sustained loss can be realized upon as an asset. But it is not the loss; it is the right to use the loss as an offset that is valuable. The market for it is restricted, of course, but this detracts nothing from its value to one in a position to utilize it.
>
> "Each of these corporations had something to contribute to a tax-saving plan. Either one alone was helpless. But I know of no moral or legal obligation to give away any legal opportunity or advantage just because its owner cannot utilize it himself.
>
> "There would have been nothing remotely illegal or improper if the management of the plaintiff corporation had demanded some compensation for its loss privileges. Indeed, it is probable that the intention of the statute permitting the consolidation of the two positions was to provide salvage for the loser, not profit for one which sustained no loss." 345 U.S. at 276-77.

The law of New York State itself has recognized that a tax loss like U&I's is a valuable asset, and that a company having a tax loss is entitled to get the benefit of it. *Case* v. *New York Central R.R. Co.,* 15 N.Y.2d 150 (1965). In that case, an 80%-owned subsidiary of the New York Central had used the Central's tax losses for three years and thereby saved more than $3.8 million in taxes. In return, the subsidiary paid approximately $3.5 million to the Central. The Court of Appeals upheld these payments, reject-

ing claims by minority stockholders of the subsidiary that the agreement under which they were made was unfair. The Court said:

> "[T]he loss shown by Central was under some rather flexible circumstances an asset to Central. It could have been carried forward for seven years (Internal Revenue Code [1954], 172, subd. [b], par. [1], cl. [C]) and there is nothing about the financial history of Central to suggest that it was clear in 1957 when the agreement was made by Mahoning [the subsidiary] that Central itself could not have believed it would have carried forward and utilized the loss in future years." 15 N.Y.2d at 158.

In other words, the New York Court of Appeals recognized the logical fallacy in the assumption that an unprofitable parent company gives up nothing of value when it uses its tax losses against the income of a profitable subsidiary.

The same logical fallacy underlies this Court's decision in *United Gas*. However, no constitutional issue was raised by any litigant in that case. The question addressed in *United Gas* was whether the Federal Power Commission exceeded its authority under the Natural Gas Act in its determination of the proper allowance for federal income taxes of the United Gas Company. Since the case has had and will continue to have an enormous impact on regulated utilities, we respectfully submit that it is time for this Court to resolve the Constitutional issue which was ignored in *United Gas*.

If the Court's ruling in *United Gas* is at all attributable —as the dissent suggests (*id.* at 249 n.3)—to an overly broad reading of *FPC* v. *Hope Natural Gas Co.*, 320 U.S. 591 (1943), certiorari should be granted to clarify *Hope* in light of its apparent conflict with *SEC* v. *Chenery*, 318 U.S. 80 (1943). The majority in *United Gas* quotes (or, as

the dissent suggests, "seizes upon") language from *Hope* which implies that in ratemaking the end justifies the means:

> "If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry under the [Natural Gas] Act is at an end. The fact that the method employed to reach that result may contain infirmities is not then important." *FPC* v. *Hope Natural Gas,* 320 U.S. 591, 602 (1943).

Assuming, contrary to our position, that the total effect of the ratemaking orders at issue here cannot be said to be "unjust and unreasonable," *Hope* should not be read to obviate judicial examination merely because the *result* of a regulatory commission's order is not unjust. There is no logical basis for taking utility ratemaking outside the rule of *SEC* v. *Chenery,* 332 U.S. 194 (1947):

> "That rule is to the effect that a reviewing court in dealing with a determination or judgment which an administrative agency alone is authorized to make, must judge the propriety of such action solely by the grounds invoked by the agency. If those grounds are inadequate or improper, the court is powerless to affirm the administrative action by substituting what it considers to be a more adequate or proper basis." (*Id.* at 196).

The basis for this administrative action—the confiscation of a valuable asset—is constitutionally impermissible. Accordingly, the petitioner respectfully requests that the Supreme Court resolve this important constitutional issue.

Conclusion

Petitioner therefore urges this Court to grant certiorari.

June 30, 1980

Respectfully submitted,

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APPENDIX A

Opinion of the Appellate Division of the Supreme Court (Third Judicial Department) dated November 8, 1979.

In the Matter of

NEW YORK WATER SERVICE CORP.,

Petitioner,

v.

PUBLIC SERVICE COMMISSION,

Respondent.

Proceeding pursuant to CPLR article 78 (transferred to this court by order of the Supreme Court at Special Term, entered in Albany County) to review that portion of a rate determination of the Public Service Commission, dated September 22, 1978, which (1) denied petitioner an allowance for Federal income tax; (2) directed that certain amounts previously collected therefor be refunded to its customers; and (3) ordered the funding of an escrow account.

Petitioner, New York Water Service Corporation (NYWS), is a wholly owned subsidiary of Utilities and Industries Corporation (U & I), a holding company which owns or controls a variety of businesses. Neither U & I nor any of its subsidiaries, other than NYWS, are regulated industries. While NYWS is a profitable enterprise and would normally incur liability for Federal income tax, U & I has reported significant losses for several years. When filing consolidated income tax returns, petitioner's income has been offset by U & I's greater losses with the result that the consolidated group has paid little or no Federal income tax since 1970. Respondent's 1975 orders in a prior rate

proceeding allowed petitioner $630,000 annually as a cost of service representing the estimated taxes NYWS would have paid had it filed a separate return, and instructed that the sum be placed in an escrow account to be used only for the purpose of contributing to income taxes actually paid or payable by the consolidated entity. If not so used, it was anticipated that the fund would be applied to reduce the rate base or would be directly refunded to petitioner's customers. No appeal was taken from those orders. Although contributions were thereafter made, no further action was taken in relation to the account until this proceeding was concluded, except for an unauthorized use to pay a prior income tax liability.

The foregoing matters became a central consideration in the disposition of petitioner's 1977 application for a further rate increase. Respondent's order, dated September 22, 1978, not only denied the requested increase, but reduced existing rates by $211,223. This determination, which in large part was founded on respondent's elimination of an allowance for future income taxes, also contained a number of affirmative directives. NYWS was required to establish an escrow account of $1,867,000, issue a refund therefrom to its customers of $630,000 plus interest—the sum collected as a tax allowance during the year 1976 when there was no actual tax liability—and to allow its 1977 and 1978 tax returns to be monitored to determine whether additional refunds should be made. Petitioner's request for reconsideration was denied and, since it failed to offer a plan for refunding the escrow monies as required by the September order, respondent directed it to grant a 5.3% reduction in each customer's bill commencing on January 1, 1979 that would satisfy the refund mandate over a two-year period.

In seeking to annul these later orders, NYWS maintains (1) that respondent has arbitrarily and capriciously de-

parted from established policy in disallowing tax liability as a cost of services; (2) that such actions has deprived U & I of a valuable asset without due process of law; and (3) that there is a lack of substantial evidence to support its finding of no tax liability to petitioner in the future.

Petitioner's initial assertion possesses surface appeal. In 1974 respondent determined that, when a consolidated tax return is filed, a regulated utility should not be controlled by the tax attributes of its parent and should be permitted to recover as a cost an amount representing the full Federal income tax liability it would otherwise incur by filing a separate return (*Citizens Water-Supply Co. of Newtown* (14 NY PSC 1353). However, that ruling contained an important exception (14 NY PSC 1353, 1357):

> [I]t is not our intention that the general policy stated here should apply in a case in which the result would be unreasonable and unjust. Such a case might arise if, for example, the consolidated companies did not pay, and were not expected in the future to pay, any taxes or a permanently reduced level of taxes is to be expected.

Petitioner's contention of a change in established policy obviously rests on *its* interpretation of the *Citizens* exception. In our view, the past tax history of U & I, and particularly the size of the loss carry forward reported on its 1977 Federal income tax return (discussed hereafter), entirely justified respondent's conclusion that a "permanently reduced level of taxes" could be expected in the future. Accordingly, we find no deviation from its policy in fixing NYWS's new rates and note that petitioner's contrary interpretation was made at its own risk.

The due process argument advanced by petitioner may be answered in a like manner. U & I and NYWS chose to file consolidated tax returns with full knowledge of the exis-

tence of the *Citizens* exception, did not protest the 1975 orders, and, thus, were or should have been aware that the cost of service charge allowed for taxes might be lost if it were not so utilized in practice. The opportunity to make the decision to consume the "valuable asset" of accumulated losses was all the process that was due.

Nor do we find any merit in the claim that the record lacks substantial evidence to support respondent's determination that there should be no future allowance for Federal income tax liability. Respondent accepted $26,000,000 as the amount of the currently available net operating loss carry forward, the sum reported on the consolidated 1977 Federal income tax return, rather than the $13,000,000 figure presented in U & I's financial report. Considering the standard for determining substantial evidence set forth in *300 Gramatan Ave. Assoc.* v. *State Div. of Human Rights* (45 N Y 2d 176), it was not improper for respondent to credit the higher amount portrayed by the return in concluding that NYWS would pay no income tax in the immediate future. We cannot overlook the fact that the record fails to demonstrate the reason for the discrepancy between the annual report and the tax return, especially since the burden of proving anticipated costs rests with the utility (*New York Edison Co.* v. *Maltbie,* 244 App. Div. 436).

Although we are satisfied that respondent's determination in this case is proper, we are troubled somewhat by the possibility that our decision might be construed as holding that when no income tax is paid there can be no cost or allowance for such an item. We have previously observed that rates should reflect the tax consequences in dealings between a holding company and its subsidiaries on an analysis of real values to avoid any inequitable advantage (*Matter of Long Is. Water Corp.* v. *Public Serv. Comm. of State of N.Y.,* 49 A D 2d 392). The problem here

involves the appropriate calculation of such expenses when only one segment of the group is a regulated entity with a guaranteed fair rate of return on its investment (cf. *Matter of Consolidated Edison Co. of N.Y.* v. *New York State Public Serv. Comm.*, 53 A D 2d 131). While there is precedent for an allocation of taxes among the various members of the whole in accordance with a pre-determined formula (see *Federal Power Comm'n* v. *United Gas Pipe Line Co.*, 386 U.S. 237), we will not disrupt the procedures adopted by respondent herein. Our powers of review are limited and the instant orders do not inhibit a prospective reexamination of the refund policy or revenue requirements upon a proper showing of actual and future tax liabilities (see *Matter of County of Orange* v. *Public Serv. Comm. of State of N.Y.*, 37 N Y 2d 762).

Determination confirmed, and petition dismissed, without costs.

MAHONEY, P.J., GREENBLOTT, KANE, MAIN and MIKOLL, JJ., concur.

APPENDIX B

The Opinion and Order of the New York Water Service Corporation dated September 22, 1978. (18, N.Y.P.S.C.——)

STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

OPINION NO. 78-23

CASE 27254—NEW YORK WATER SERVICE CORPORATION—Water Rates

OPINION AND ORDER DETERMINING REVENUE REQUIREMENT

Issued: September 22, 1978

Appendix B

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Appendix B

STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

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Appendix B

STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

COMMISSIONERS:

Charles A. Zielinski, Chairman
Edward P. Larkin
Carmel Carrington Marr
Anne F. Mead
Karen S. Burstein

CASE 27254—NEW YORK WATER SERVICE CORPORATION—Water Rates

OPINION NO. 78-23

OPINION AND ORDER DETERMINING REVENUE REQUIREMENT

(Issued September 22, 1978)

BY THE COMMISSION:

On October 24, 1977, the New York Water Service Corporation (NYWS), a wholly owned subsidiary of Utilities and Industries Corporation (U&I), filed tariff revisions to be effective November 25, 1977 designed to increase its annual revenues by $1,742,019, or about 29%. NYWS has subsidiaries of its own, one of which is the Merrick Water District, the only utility operation of U&I. It is the rates for Merrick District operations that are in issue in this proceeding. The proposed tariff revisions have, by interim orders, been suspended to September 24, 1978. Public hearings, including a day and evening public statement session, were held in Nassau County and New York City on January 10, 11, February 2, 3 and March 27, 28, 1978.

Appendix B

On June 26, 1978, Administrative Law Judge David Schechter issued a recommended decision in which he concluded that a rate *reduction* of $211,223 was required. Briefs on exceptions have been filed by the company, staff, the Joint Committee of Fire Districts and the Town of Hempstead. The company continues to support its requested rate increase. Staff argues for an annual rate decrease of $760,000. Both the Fire Districts and Hempstead support staff's position.

FEDERAL INCOME TAXES

Escrow Account

In the last NYWS rate proceeding, Case 26788, we issued, on December 18, 1975, an Order on Rehearing Adding Condition to Federal Income Tax Allowance. It is now the focal point of the major issue in this case. That Order contained the following directive:

> . . . we direct New York Water Service to place the $630,000 annual revenues that we have allowed for taxes in a separate escrow account, from which funds may be withdrawn only for the purpose of making contributions to the consolidated system for income taxes actually paid or payable. Should funds accrued for a given calendar year not be used for income taxes, the remainder, together with interest earned on the funds, shall be used to reduce rate base as consumer contributed capital, or shall be credited to the benefit of the customers in such other manner as the Commission may hereafter direct.

The Commission orders:

1. The New York Water Service Corporation shall establish a separate escrow account for Federal income taxes in a responsible banking institution or

institutions. Beginning in December 1975 and continuing each month thereafter, the company shall credit in such account an amount derived by dividing the revenues from the corresponding month in the year ended October 31, 1975, by the total revenues in such year and multiplying the quotient by the total Federal income tax allowance made by the Commission in Opinion No. 75-33. The company, from time to time, may invest the monies in the account in short-term, high quality marketable securities provided that funds equal to not less than the amount so invested be restored to the account at such time as the account is drawn down to pay Federal income taxes or as otherwise directed by the Commission.

2. When the amount of Federal income taxes paid or payable for calendar year 1976 by the consolidated group of which New York Water Service Corporation is a part become known, the company shall petition the Commission for disposition of the special escrow account. No withdrawals shall be made from the account until authorized by the Commission, except as allowed in Clause 1 above.

Our purpose in these orders was to implement the exception to our consolidated income tax policy, as explained in our *Citizens Water-Supply Company* rate decision*:

> We are now persuaded that in this and other like cases our general policy should be that only those tax deductions properly attributable to the regulated operations under scrutiny should be used in determining a utility's tax liability for rate purposes. We have always followed the principle that nonutility

* Case 26366, *The Citizens Water-Supply Company of Newton,* 14 NY PSC 1353, 1356-7 (1974).

> income or loss (below the line items) is disregarded for ratemaking purposes. As a corollary to this rule, the income tax effect of this nonutility income or loss is also excluded from consideration, except for interest expense. It is illogical to exclude the nonutility items and their tax effect if the utility is not a member of a group that files a consolidated income tax return, but to consider the tax effect of nonregulated losses if a consolidated tax return is filed.
>
> We will, however, continue in our rate decisions to give effect to tax deductions of affiliates reasonably attributable to regulated operations, *e.g.,* as we have done in some of the New York Telephone Company and other rate cases in regard to interest on parent company debt. *In addition, it is not our intention that the general policy stated here should apply in a case in which the result would be unreasonable and unjust. Such a case might arise if, for example, the consolidated companies did not pay, and were not expected in the future to pay, any taxes or a permanently reduced level of taxes is to be expected.* (emphasis added)

The question presented here is what could NYWS properly do with the dollars placed in the escrow account that was created by the 1975 Order.

The company has admitted that it unilaterally withdrew $620,000 from the escrow account during 1977—virtually the entire balance at that time—for partial payment of a tax deficiency assessed against its parent, U&I, for the years 1966 and 1967. In March, 1978, the company deposited $840,000 in the escrow account and continues to deposit $52,500 per month. It is undisputed that the escrow account would total $1,867,000, including interest at 5.25%, compounded quarterly, by September 24, 1978, except for the withdrawal. (The $840,000 deposit represents 16

monthly deposits of $52,500. The account is short the amount of the withdrawal and interest that would have been accumulated on the $1,770,000.) The company states that, in addition to the $620,000 it has already paid to the IRS for the 1966 and 1967 deficiencies, a payment in excess of $3,693,540 will be paid in the near future for U&I tax deficiencies for the period 1958-1967. A third payment of more than $2,000,000 will be due for years subsequent to 1967. The Internal Revenue Service is conducting an ongoing audit of U&I, which may encompass the period for which the escrow account has been in effect.

The company makes three arguments to justify its application of the escrow account to past tax deficiencies.

First it claims that the provisions of the rehearing order permit its action. It points to the language in Ordering Clause 1 which it reads to say that "the account" can be "drawn down to pay Federal income taxes or as otherwise directed by the Commission." It then argues that "[s]ince the clause provides for the alternative 'or as otherwise directed by the Commission,' there is no requirement for an order of the Commission for 'a draw down to pay Federal income taxes.' Clause 2 expressly states 'no withdrawals shall be made from the account until authorized by the Commission, except as allowed in Clause 1 above.' Clause 2 thus confirms its interpretation of Clause 1, *i.e.*, that no authorization by the Commission is necessary for tax payment withdrawals 'allowed in Clause 1'."* NYWS concludes that if the Commission had desired to limit withdrawals for 1976 it would have so provided.

Judge Schechter views the condition that the escrow fund be used for income taxes only for 1976 and beyond as implicit in the manner in which we set rates—on a prospec-

* Brief on Exceptions, pp. 6-7.

tive basis. He concluded that the company's argument was an unpersuasive misconstruction of our ordering clauses. In point of fact, Clause 2 specifically provides for disposition of the dollars in the escrow account when the taxes for 1976 become known. Our Order clearly did not contemplate use of escrow funds for taxes due for years prior to those for which rates were set. Judge Schechter's analysis of this claim is correct.

The company's second argument relies on an analysis, not of the order in question, but rather of the dissenting opinion of former Commissioner Berlin in the Opinion and Order Determining Increased Revenue Requirements and Revising Rate Design.* Judge Schechter does not discuss this argument, rejecting it by implication. We agree that the argument is without merit. If we did not know the intent of the rehearing order, we might very well resort to an analysis of the dissents. But this intent is clear. What NYWS is attempting here is to petition for reconsideration of that order on rehearing, arguing that the establishment of the escrow account was misguided in light of Commissioner Berlin's asserted mischaracterization of the company's tax history. At this point, NYWS' argument is irrelevant. All that is in issue now is the construction of the meaning of the rehearing order and the enforcement of its provisions.

The company's third contention rests on what it terms "the equities." Here, NYWS again resorts to arguing something other than the case at hand. And here too Judge Schechter has rejected the company's argument without discussion. The company goes back to past cases, the 1974 *Merrick District* case** and the 1973 *Woodhaven* case,***

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* 15 NY PSC 2116, 2129.

** *Utilities and Industries Corporation,* 14 NY PSC 732.

*** *Utilities and Industries Corporation,* 13 NY PSC 1307.

arguing that the Commission underestimated the taxes due on the consolidated tax returns in those proceedings. This argument is irrelevant to our 1976 decision. Moreover, while the Commission followed a different consolidated tax policy at that time, it was a reasonable policy and there is no constitutional obligation for a regulatory commission to make up deficiencies from a past rate period.

In summary, we find the company's justifications for its use of the escrow funds to pay for out-of-period tax deficiencies unpersuasive. We turn now to the question of how to treat the funds in the escrow account.

Judge Schechter notes that the ongoing IRS audit may affect group liability for the years during which the rates set in the last rate case were in effect. He concluded, therefore, that it would be premature to allow disposal of the funds in the escrow account. Staff proposes that the balance in the escrow account be refunded because the company incurred no 1976 tax liability. It suggests a refund over a six-year period by imputing $300,000 in annual revenues to the ratepayers. It would credit the amount of the fund against rate base, with a resulting increase to rate base as the refunds are made. Hempstead argues for a refund over a two rather than a six-year period. Staff supports its recommendation by arguing that the company is in an advantageous interest coverage situation (4.88x) and that the refund will not significantly affect the company's ability to refinance $5.8 million in long-term debt in 1980. Staff further argues that the rehearing order specifically provided for such a disposition in the event of no tax liability.

Judge Schechter found that it may not be in the ratepayers' best interest to refund the amounts in the escrow account in light of both the continuing audit and the future refinancing. He recommends, therefore, that the account be

maintained by crediting the full $1,867,000 against rate base and, when the question of tax liability is settled, the fund be used, if necessary, for payment of any 1976 tax deficiency or any taxes due for the period during which rates set in Case 26788 were effective. The remainder, if any, would then be refunded to ratepayers. The company excepts to this recommendation.

U&I has paid no taxes for 1976 and $630,000 has been placed into the escrow account for tax purposes. The company asserts that it may still be assessed taxes for this period. We construe the condition in our December 18, 1975 Order as contemplating refunds from the escrow account on the basis of the tax return filed by U&I for the applicable period. The terms of the condition do not depend on the always present possibility of subsequent assessments of tax deficiencies. On the other hand, if a change in the 1976 liability were known before disposition of the escrow account, we would take that into consideration. We do not find the company argument on this point persuasive. The facts it now relies on were brought to light late in the hearings and remain, at this time, as no more than untested assertions. We will, therefore, direct a refund of the $630,000 (plus interest at 5.25%) collected to pay a 1976 tax liability, unless the company, by October 31, 1978, demonstrates to us, at least *prima facie,* that it is reasonably certain to be assessed some tax deficiency for this period. The refund should be made by credits to its current customers over a two-year period which is consistent with staff's recommendation because only one-third of the escrow account (plus interest) will be refunded at this time.

For the period following 1976 to the effective date of the new tariffs, the company has yet to file its income tax returns. In view of the possibility that some tax liability will be incurred for these tax periods, the escrow account

should be maintained and contributions (with interest) continued up to the date of this Order. We will direct our staff to monitor the company's tax filings and report to us recommending disposition of the remaining funds subsequent to the filing of each of the company's tax returns for the remaining periods.

Propriety of a Federal Income Tax Allowance in this Proceeding

Judge Schechter found it unnecessary to determine whether a tax allowance should be provided for in this case since the escrow account's reserve is far greater than any possible tax obligation of the company. The company excepts, arguing that the record demonstrates that taxes will be paid by the consolidated group in the future. Staff argues that sufficient tax carry-forward losses are available to offset any possibility of tax liability for the enterprise and, therefore, that we need not provide for tax payments in rates in accordance with the exception set forth in the *Citizens* case (see *supra,* pp. 3-4). The consolidated Federal income tax return for the period ending March 31, 1977 shows that carry-forward losses are available in the amount of $26,712,030. But the company claims that the correct amount of carry-forward losses is $13,600,000, a figure set forth in its Annual Report for the year ended March 31, 1977. The lower figure results, according to the company, from limitations on the applicability of losses which relate to specific companies rather than the consolidated group as a whole. NYWS further states that the $13,600,000 was "substantially utilized by the realized gains on the sale by subsidiaries of the consolidated group of the investment in Elgin National Industries, Inc. in July and October 1977."* The company further states that sales of

* Brief on Exceptions, p. 27.

unprofitable operations in 1977 will reverse tax losses.

Staff asserts that the only accurate evidence of the firm's tax liability is the Federal income tax return, because it is governed by the rules and regulations of the Internal Revenue Service. Staff seeks to support its argument by noting that an 80%-owned subsidiary of the parent is not included in the annual report, but is part of the FIT return. Further, staff relies on a statement from the annual report with regard to the tax deficiency of over $6,000,000 assessed by the IRS to develop an argument that the $26,712,030 is the correct figure. The annual report states:

> The amount of any eventual liabilities would not have a material effect on the consolidated financial position results of operations of the company.

Staff argues if $13,600,000 is the correct figure, and if it would be further reduced by gains on the sales of Elgin as the company claims, the $6,000,000 tax assessment would have to have a material effect on the company. Staff concludes that if the annual report statement is correct, $26,712,030 must be the correct figure.

The company claims that the limitation on applying losses of a single subsidiary resolves the inconsistency claimed by staff. But staff claims that even if such separate return limitation year (SRLY) losses exist, they can be applied against tax deficiencies before the year in which the SRLY losses were incurred. In effect, therefore, they are not lost; they are merely limited.

Like the escrow account issue, the company again relies on its untested assertions that it will be faced with a tax bill for the period of new rates. This does not provide a proper basis for assessing the company's possible exposure to a prospective tax liability. At this point, we will make no allowance for F.I.T., but we stand ready to reexamine

this finding, on a prospective basis, upon a proper showing of the likelihood of an actual tax liability for the reasons specified during the proceedings, namely, that sales of investments have eroded the tax loss carry-forward and that sale of unprofitable operations will reverse tax losses. In any such showing, the company should also reveal the tax effect of any transaction which will increase tax losses.

OPERATING EXPENSES

Administrative and General Expenses—General Office and Corporation

The issue presented here is how to allocate expenses common to the 45 enterprises that comprise U&I, so as not to allow subsidization of nonjurisdictional activities by the utility. Staff recommended that a 10% allocation factor be applied to general office charges, which it claims best represents the portion properly allocable to Merrick. The 10% was derived from a comparison of a three-year average of the utility's revenues, operating expenses, and total assets with that of the consolidated enterprise. The company offered its own allocation which, it claims, is derived from its actual knowledge of the duties and responsibilities of each employee and includes an estimation of the percentage of time each employee devotes to utility operations. We rejected this method in the company's last rate case, and, we again find it unpersuasive. The company seeks to support its results by arguing that they have been examined and termed reasonable by an independent consultant. During the hearings, the consultant admitted, however, that he had not observed the operations of the company in developing his opinion. Rather, he relied on assertions of representatives of the company. As a practical matter, it makes little sense to allocate the work of every employee

into nonutility and utility operations for regulatory purposes, since there is no practical way that such an approach can be tested. Staff's method is clearly a more sensible approach.

But NYWS challenges staff's method for deriving its allocation factor. The company points to staff's failure to make consolidating adjustments that eliminate alleged double counting. It objects to the comparison of utility revenues, expenses and assets with the aggregate of those of the group since, it claims, assets such as stock held by the parent in a subsidiary are counted along with the assets of the subsidiary. According to NYWS, this "double counting" should be eliminated by comparing utility revenues, expenses and assets with the group, as consolidated. The company also points out that staff's procedure here varies from the one it used in the last case in that a comparison of these items with those of the group as consolidated was made in Case 26788.

We believe staff's procedure, which is, in essence, a refinement of the approach it offered and we adopted in the last case, is sound in the circumstances of this particular corporation. NYWS has a number of subsidiaries with extensive activities even though they are, nominally, "non-operating" subsidiaries. Staff's method would properly allocate overheads to these subsidiaries to assure that the cost of these activities are not borne by other subsidiaries who do not benefit from them. Likewise, transactions involving sale of investments, assets, and exercise of options as listed in the annual report, and testified to by witnesses in relation to the income tax allowance require managerial time.

The company also objects to the inclusion of interest in expenses because "interest expense has little or no bearing

on 'Administrative and General Expenses' and cannot be considered an appropriate inclusion in the calculation of the allocation percentage to be applied thereto."* We agree that the inclusion of interest represents an actual double counting. It should have been excluded from staff's formula. But there is no need to adjust staff's result here because, due to rounding, the exclusion of interest from the formula causes no change in the result.

Staff's method offers the virtues of simplicity and easy verification. Moreover, it cuts across a broad band of activities as well as 45 entities, so there is no reason to believe that inherent biases have not been randomly eliminated.

Judge Schechter, although endorsing staff's method, did not agree with its final step: staff's use of a three-year average of overheads. The Judge concluded that the last record data for the year ended March 31, 1977 best represents the future. Staff excepts, arguing that the consolidated structure is in such a continuing state of flux—new subsidiaries are being added and others eliminated regularly —that biases peculiar to any year are eliminated by averaging three years. We agree that U&I has had a changing corporate structure. It is, therefore, best reflected by a three-year average method. We will adopt staff's method in its entirety.

Union Payroll and New Billing System

Staff excepts to the Judge's recommendation that the 1977 calendar year payroll be adjusted to reflect the addition of two meter testing employees. Staff argues that one employee would be sufficient because, according to a ma.-

* Brief on Exceptions, p. 61.

agement efficiency review conducted by Peat, Marwick, Mitchell & Co., employees now performing redundant clerical operations could be used for this purpose. The company asserts that this redundancy was eliminated immediately after the report was received so there is no one within the company who could be used for this purpose. Judge Schechter further found that this employee was needed by NYWS to allow it to comply with our meter testing requirements. Staff fails to address this concern.

Judge Schechter also recommended allowing the company an additional operating expense of $36,013 to reflect the installation of a new billing system. Staff excepts, arguing that its proposed allowance of $2,680 takes into account a savings of the expenses related to two employees who will be replaced by the system. The Judge terms this prognostication by staff speculative for the near future. Staff argues that all of the expense here is speculative, but observes that it is always necessary to estimate future expenses. The company argues that the expenses are fully documented by the contract for the system and should therefore be allowed. We must assume that the company contracted for the new system in order to increase productivity and realize savings. What is questionable, here, is the *level* of savings to be achieved by this new system. We think it is reasonable, in these circumstances, to allow NYWS the full expense of the new billing system, but expect that the expenses associated with one of the two new employees for meter testing will be provided for by savings realized from the implementation of the new billing system. This result will also provide an incentive for NYWS to install promptly and utilize effectively the new billing system.

Supervisory Employee Payroll

Staff proposes to make the necessary adjustments for the wage increase that went into effect on April 1, 1978.

Such adjustments represent a necessary allowance for what will be actually incurred expenses. There is no controversy over this post-hearing adjustment and it will be adopted.

Insurance

Staff excepts to the Judge's rejection of its $979 reduction in insurance expense, an adjustment designed to reflect refunds that are likely to be received. Staff states that refunds have been significant in the past and are likely to continue in the future. The Judge found that refunds are speculative. We find the company's estimate reasonable and see no reasonable basis for making any adjustment. Staff's exception is denied.

Transportation Expense

The Judge conditionally adopted the company's adjusted transportation expense level pending staff's review and comments in the post-hearing phase. The issue here relates to the salvage value of the nine vehicles the company is replacing with leased vehicles. Staff asserts, based on its reading of used car advertisements in the newspaper *Newsday,* that each vehicle has a value of $1,000, or $9,000 in total. The company estimates their total value at $2,000. Neither party has provided us with a sound basis for its estimate of the value of these vehicles. We will, therefore, treat their estimates as providing a reasonable range of values. Lacking persuasive evidence to support the high or low end of the range, we will use its midpoint as the most reasonable. Accordingly, we will set the salvage value at $5,500. Staff has offered a maintenance saving adjustment that, it says, will result from a substitution of the leased vehicles for the company-owned vehicle. The com-

pany does not object to this adjustment, and it will be adopted.

Service Related Issues

The Town of Hempstead excepts to the Judge's failure to adopt its recommendation that the Commission investigate the company's maintenance program. Hempstead claims that it does not wish to be placed in the same position as was the City of Glen Cove in 1966 when that municipality was "forced" to condemn the holdings of NYWS because of a "breakdown" in the system caused by the company's failure to maintain adequately the system. Our staff monitors the service of all water companies on a regular basis and has not detected any problems with the company's maintenance program. We will require that staff continue to monitor NYWS maintenance and bring any service problems to our immediate attention for proper Commission action.

Both Hempstead and the Fire District except to the Judge's recommendation that staff should be directed to monitor the company's maintenance and repair of fire hydrants. Hempstead calls this inadequate, seeking instead a service related reduction in rates. A reduction in rates would certainly not assure improved maintenance of the hydrants; in fact, it probably would cause just the opposite result. Again, we believe the sounder course to follow is to rely on staff surveillance of the company's maintenance program. Any problems encountered by the excepting parties should be reported to staff immediately and these will be fully investigated. The exceptions are denied.

Appendix B

RATE OF RETURN

Return on Equity

Judge Schechter rejected staff's downward adjustment to return on equity to account for the company's high equity ratio (49.4%), which is 15% higher than the industry average. Staff reduced the 12% return indicated by its discounted cash flow (DCF) analysis to 11.5% for this reason. The Judge did not find staff's reasoning persuasive and staff now excepts.

The company claims that staff's exhibit containing the ten water companies that served as the proxy for NYWS does not demonstrate an inverse relationship between equity capitalization and rate of return. Although staff's exhibit does not clearly establish its point, the argument it advances is theoretically correct and similar adjustments have been made many times in the past to reflect the reduced risk inherent in this type of capital structure.* We believe, however, that in light of the changed financial market conditions since the testimony was presented in this case, *i.e.*, generally higher interest rates, a reduction down to 11.5% would be unwarranted. We will allow a return on equity of 11.75% to reflect the company's high equity ratio and more recent interest rate trends in the marketplace for capital funds.

Erosion Allowance

The Judge recommends an overall 8.08% return, which includes a 12.0% return on equity and a 0.3% allowance for erosion of earnings. Staff excepts to the Judge's recom-

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* Most recently in Case 27143, *Midstate Telephone Corporation—Telephone Rates*, 18 NY PSC (Opinion No. 78-2, issued January 12, 1978).

mendation that the company be allowed a 0.3% erosion allowance to provide a measure of protection in view of present inflation, the 1980 maturity of the company's long-term debt, and the distribution by Long Island Lighting Company of free shower heads that are designed to reduce the amount of water used in showers by 60%. We allowed NYWS a 0.3% additional return factor in the company's last rate case. The company, in opposing staff's exception, further points to the fact that it has not been provided with a market-to-book premium in the return on equity.

The erosion allowance will be used here in view of other elements of the case, *e.g.*, use of an historic test year, and lack of forecast revenue and expense data. It would have been preferable to have adjusted revenues, if sales of water are, in fact, likely to be reduced because of the showerhead flow restrictions, and to have included an explicit adjustment for the anticipated effect of inflation on expenses. We will allow the adjustment in this case but serve notice here that we will not allow a nonspecific erosion factor in future cases where the company is, like NYWS, perfectly capable of presenting a case in compliance with our *Statement of Policy on Test Periods in Major Rate Proceedings*, issued November 23, 1977 or, at least, of examining individual effects of the items, such as inflation, that constitute the need for an erosion allowance. We will expect NYWS to use these approaches in the future.

FINANCIAL INCONSISTENCIES

The Fire Districts requests that we require the company to use independently audited figures in its exhibits. It asserts that there are numerous inconsistencies between numbers submitted in this case and numbers recorded on Form 10-K filed with the Securities and Exchange Com-

mission (SEC). But these arguments fail to recognize the purposes of Form 10-K which are not related to the setting of utility rates. The differences in the forms in and of themselves, are irrelevant. We have reviewed both submissions and find that all differences between numbers submitted to us and those submitted to the SEC can be fully explained by the purposes for which the numbers are presented. The exception is denied.

SECOND-STAGE FILING

The company requests permission for a second-stage filing on January 1, 1979 to cover the following: (1) the 9% wage increase for union employees; (2) an increase in the F.I.C.A. tax base to $22,900; and (3) the increased cost of debt that will result from its refinancing of bonds which become due on May 1, 1980.

Staff argues that: (1) we should reduce the 9% to reflect expected productivity gains; (2) the F.I.C.A. base increase has not yet been approved and should not be allowed in the second-stage filing unless it actually occurs; and (3) it is premature to allow a filing now for an increase that will not occur until May 1, 1980. In addition, staff suggests that we order the company to stagger its long-term refinancing to prevent all of it from coming due on the same date, as is now the case.

First, we will require that the company's 9% wage increase be offset by 1.5% to account for productivity that it surely must expect to realize in light of the size of the wage increase, unless the company can demonstrate, with a fully documented study filed in support of its second-stage filing, that such productivity gains cannot reasonably be achieved.

Second, we will allow the increase for F.I.C.A. only if the increase in the base has been approved at the time of the second-stage filing. Finally, we will not allow for an increased cost of debt that will not occur for over 1½ years. To allow the company to file on January 1, 1979 for unknown increases over 1½ years in the future for these items would be not only violative of regulatory procedure, but also would constitute an implicit endorsement of any terms the company arranges for refinancing. In this regard, we expect the company to stagger its refinancing to avoid putting excessive pressure on itself when the refinanced debt becomes due.

POST-RECORD CHANGES

Franchise and Real Estate Taxes

By letter dated August 28, 1978, NYWS requests that it be allowed $33,161 for increases in franchise and real estate taxes. At this time, this increase merely reflects increased assessments at the old tax rates. In the second-stage filing, once the actual tax bill is known, we will allow the company to recover its actual taxes, except that the recovery of assessment related increases will be limited to 90%, to provide and preserve an incentive to challenge assessments.

Operation and Maintenance Expenses

The company requests an allowance of $2,337 for increases in electric repairs. Staff opposes this request since the company has only delineated an increase in the hourly rate, but has failed to determine the quantity of work. It seems clear that this item is one that has already been reflected implicitly in the erosion allowance which we provided, as discussed above, to meet the increased costs that the company will be facing in various categories.

Appendix B

CONCLUSION

Our resolution of the issues raised in this case indicates that NYWS does not require additional revenues and that exsiting rates must be reduced to the extent set forth in Appendix A. We direct the company to file revised tariff leaves to reflect the revenue requirement set in this case.

THE COMMISSION ORDERS:

1. New York Water Service Corporation is directed to cancel the revised tariff leaves listed in Appendix B on or before September 23, 1978.

2. On or before September 29, 1978, New York Water Service Corporation is directed to file such amendments to its tariff schedules that will produce annual revenues in an amount and manner consistent with the findings and conclusions in the foregoing decision. The amendments shall not take effect until approved by the Commission.

3. New York Water Service Corporation is ordered to maintain an escrow account of $1,867,000, that will accumulate interest at the rate of 5.25% compounded daily less the escrow agent's fee, with a responsible banking institution or institutions. The escrow agent should execute a notarized statement that it will not under any conditions release these funds without written permission from the State of New York Public Service Commission.

4. New York Water Service Corporation is directed, before October 31, 1978, to file a plan to refund by credit to its current customers over a two-year period $630,000 plus accrued interest on that amount and to implement that refund (or lesser amount) as may be directed by subsequent order of the Commission.

5. Staff is directed to analyze and report upon the tax returns actually filed by this enterprise for tax periods during which rates set in Case 26788 were in effect, as they are filed, to determine whether any tax has been paid and whether any refunds of remaining funds in the escrow account should be made.

6. Except as here granted, all exceptions to the Administrative Law Judge's recommended decision are denied.

7. Except as here modified, the findings and conclusions of the Administrative Law Judge's recommended decision are adopted as part of this Opinion and Order.

8. This proceeding is continued.

By the Commission,

(SEAL) (SIGNED)

SAMUEL R. MADISON
Secretary

Appendix B

NEW YORK WATER SERVICE CORPORATION

Merrick District

Revenue Requirement

Line		
1	Rate Base—Per Commission	$14,195,926
2	Allowed Rate of Return	8.48%
3	Return Required (Line 1 x Line 2) ..	1,203,815
4	Operating Income—As Adjusted	1,250,176
5	Excess Return	46,361
6	Excess Revenue—Before Revenue Taxes & Uncollectibles (Line 5 ÷ .96126)*	$ (48,229)

* 100% Less (Revenue Tax 3.75% + Uncollectibles .124%).

Appendix B

NEW YORK WATER SERVICE CORPORATION

MERRICK DISTRICT

COMPUTATION OF RATE OF RETURN

Twelve Months Ended March 31, 1977

	Per ALJ R.D. App. B, P.2		Commission Adjustments	As Adjusted
Operating Revenues	$ 5,981,303		$ —	$ 5,981,303
Operation & Maintenance ...	2,689,866	(1)	(49,280)	2,640,586
Depreciation	304,091		—	304,091
Taxes Other Than FIT:				
Payroll Taxes	68,437	(2)	(1,170)	67,267
Property Taxes	1,565,672		—	1,565,672
Revenue Taxes	153,511		—	153,511
Total Taxes Other Than FIT	1,787,620		(1,170)	1,786,450
Total Operating Expense ...	4,781,577		(50,450)	4,731,127
Operating Income Before FIT	1,199,726		50,450	1,250,176
Federal Income Tax	—		—	—
Operating Income	$ 1,199,726*		$ 50,450	$ 1,250,176
Rate Base	$12,335,227	(3)	$1,860,699	$14,195,926
Rate of Return	9.73%			8.81%

* Shown as $1,119,726 on R. D.

Appendix B

NEW YORK WATER SERVICE CORPORATION

Merrick District

Explanation of Adjustments

1. Operation and Maintenance Expense

(a) To allocate General Office Charges at 10% proposed by staff.

	ALJ	Commission	Adjustment
General Office & Corporate	$ (177,094)	$ (194,748)	
Executive	(5,315)	(5,551)	
Telephone & Telegraph	(9,075)	(9,466)	
Printing & Stationery	(4,837)	(4,947)	
Other Office Expense	(1,573)	(1,626)	
Postage	(801)	(819)	
Tax Consultant Fees & Expense	(8,640)	(9,700)	
Auditing Expense	(12,802)	(14,835)	
Pensions	(17,533)	(19,280)	
Employee Welfare Expense	(8,336)	(8,946)	
Other Misc. General Expenses ..	(1,392)	(1,476)	
Rents	(10,516)	(11,270)	
Maintenance of Office Furniture	(332)	(414)	
	$ (258,246)	$ (283,078)	$ (24,832)

(b) Allowance for one additional meter testing employee rather than two allowed by ALJ ..... $ (13,645)

Wage increase related to additional employee ..... (1,040)

Compensation Insurance related to additional employee ..... (1,049)

Pension Expense related to additional employee ..... (1,517)

Employee Welfare Expense related to additional employee .... (938)

Total Adjustment ..... $ (18,189)

Appendix B

	ALJ	Commission	Adjustment
(c) Transportation Expense			
Per ALJ		$ 21,290	
Per Staff—Brief on Exceptions, App. A		13,421	
Difference		$ (7,869)	
Adjust for salvage			
Per Staff—2 year average	$ 4,500		
Per Commission—2 year average	2,750		
	$ 1,750		
O&M at 92.01%		$ 1,610	
Total Adjustment			$ (6,259)
Total Operation & Maintenance Expense			$ (49,280)
Payroll taxes on additional employee			$ (1,170)
3. Increase Rate Base			
Tax Escrow Account			$1,867,000
Working Capital effect of Adj. 1 ($49,280 X 8.81%)			(4,342)
Allocate Office Furniture & Equipment at 10%			(1,959)
			$1,860,699

Appendix B

NEW YORK WATER SERVICE CORPORATION

Merrick District

Calculation of Cost of Capital

	Pro Forma Capitalization	% Of Total	Cost %	Weighted Cost
Long-Term Debt	$ 5,800,000	40.9	3.31	1.35%
Customers' Deposits	443,994	3.1	8.00	0.25
Common Equity	7,951,932	56.0	11.75	6.58
Total	$14,195,926(1)	100.0		8.18
Plus: Allowance for Erosion of Earnings				0.30
Pro Forma Cost of Capital				8.48%

(1) The rate base level adopted in this decision.

Appendix B

NEW YORK WATER SERVICE CORPORATION

30 Revised Leaf No. 32

25 Revised Leaf No. 67

24 Revised Leaf No. 89

APPENDIX C

The Order of the New York Water Service Corporation (dated November 27, 1978) denying Petition for Reconsideration.

STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

At a session of the Public Service Commission held in the City of Albany on November 9, 1978

COMMISSIONERS PRESENT:

Charles A. Zielinski, Chairman
Edward P. Larkin
Harold A. Jerry, Jr.
Anne F. Mead
Karen S. Burstein

CASE 27254—NEW YORK WATER SERVICE CORPORATION—Water Rates

ORDER DENYING PETITION FOR RECONSIDERATION

(Issued November 27, 1978)

BY THE COMMISSION:

On October 18, 1978, New York Water Service Corporation (NYWS) petitioned for rehearing on numerous aspects of Opinion No. 78-23, issued September 22, 1978. Staff has filed a response opposing the arguments raised by NYWS.

Appendix C

1976 TAX LIABILITY

In Opinion No. 78-23, we stated our intention to order NYWS to refund $630,000 (plus interest at 5.25%) that had been collected to protect against a possible 1976 Federal income tax liability unless the company could make a *prima facie* showing, by October 31, 1978, that it would, in fact, incur a 1976 income tax liability. NYWS has responded by submitting one page from the consolidated company's tax return for fiscal year 1975 (which includes the first three months of 1976). It shows a tax liability of $19,857. NYWS fails, however, to say whether this tax results from some activity related to calendar year 1976 or otherwise to demonstrate that it is reasonably certain to be assessed a deficiency for that period. Even under the most liberal interpretation, therefore, this submission does not constitute a *prima facie* showing of 1976 Federal income tax liability. Accordingly, we shall order the refunding of $630,000, plus interest, in the manner discussed below.

REFUND PLAN

We directed NYWS to file a plan, before October 31, 1978, to refund the $630,000 (or a lesser amount) by credit to current customers over a two-year period. The company has not complied with our order. Instead, it argues that the following items should be subtracted from the tax escrow account: (1) the sum of the differences between its allowed rate of return and its actual earnings in the past; (2) taxes that the Commission should allow in this proceeding; and (3) imputed interest on these past sums it has foregone. The company's first request—that the amounts by which it failed to earn its allowed rate of return be deducted from the escrow account—would constitute retroactive ratemaking, and, must, therefore, be rejected. The question of prospective tax liability raised by the second request is fully addressed *infra*.

Appendix C

The company's failure to file a refund plan requires that we, ourselves, design one along the lines specified in our Opinion. Beginning on January 1, 1979, the company should credit to each customer's bill an amount equal to 5.3% of the bill as computed under existing tariffs.* In January, 1980, we will reconcile the amount actually refunded with the percentage refund to ensure that neither too little nor too much is being returned. In January, 1981, at the end of the refund period, we shall reconcile the total actual amount refunded by use of this procedure with the $630,000 plus accrued interest that should have been paid back, and will, at that point, order the refund of any residual amount. The company should file with our staff a monthly summary of the refunds made under this procedure.

ESCROW ACCOUNT

We ordered NYWS to maintain $1,867,000 in an escrow account with a responsible banking institution that would be required to agree, in a notarized statement, not to release any funds in the account without our written permission. The company argues that there is no need to maintain this escrow account because the health of its balance sheet provides adequate assurance of its ability to make the refunds. But our reason for taking such pains to segregate this cash was to provide additional protection to the ratepayers in light of the company's failure to abide by our previous order on the subject.** We see no reason

* $315,000 (one year's refund) equals 5.3% of the company's projected rate year revenues.

** The company withdrew funds from the account, which was established for possible payment of post-1976 Federal income taxes, to pay deficiencies assessed against it by the Internal Revenue Service for 1966 and 1967 taxes.

to alter this requirement. The company is directed to establish an escrow account under the terms of our Opinion within five business days of the issuance of this Order.

PROSPECTIVE TAX LIABILITY

During the case, NYWS contended, but failed to prove, that it was likely, for various reasons, to incur an actual prospective tax liability. In our Opinion, we offered the company a further opportunity to prove this claim. It responds only that there is no way to know what may result from future tax audits. That assertion provides no basis for an income tax allowance, and there is no reason to change our principal decision in this respect.

NEW ASSERTIONS AND REQUESTS

The company requests a hearing or conference at which it proposes to demonstrate the validity of its "refund plan" and its claims about future and past tax liabilities. We believe that the procedure that we set forth in our Opinion, which gave NYWS ample opportunity to prove the assertions it had made regarding 1976 and prospective tax liability, was more than fair. The company has simply failed to avail itself of this opportunity. Its request for an alternative procedure is denied.

The only thing new that appears in the company's petition for rehearing is a claim that its common equity ratio should be adjusted for the carry-forward losses generated by its nonutility operations. But even if this claim is theoretically sound, which is questionable, there is no record basis for the assertion: it appears for the first time in the NYWS petition for rehearing. Moreover, NYWS has submitted no computations to demonstrate how the common equity ratio should be adjusted or what the result of an adjustment would be. This adjustment is rejected.

Appendix C

The Commission orders:

1. New York Water Service Corporation is directed to establish, by December 4, 1978, an escrow account in the amount of $1,867,000 with a responsible banking institution. The account will accumulate interest at the rate of 5.25% compounded daily, less the escrow agent's fee, and the escrow agent shall execute a notarized statement that it will not release any funds from this account without written permission from the New York State Public Service Commission.

2. New York Water Service Corporation is directed to credit each customer's monthly bill, beginning on January 1, 1979, with an amount equal to 5.3% of the bill as computed under existing tariffs, in order to effectuate a $630,000 refund over a two-year period. The company shall file with the Commission a monthly summary of the refunds made under this procedure, and the amounts so refunded will be reconciled with the company's total refund obligation in the manner described in this Order.

3. The petition for rehearing of New York Water Service Corporation, filed October 18, 1978, is denied in all respects.

4. This proceeding is continued.

By the Commission,

(SEAL) (SIGNED) SAMUEL R. MADISON
Secretary

APPENDIX D

The Order of the New York Court of Appeals dismissing the appeal, dated April 1, 1980.

STATE OF NEW YORK
COURT OF APPEALS

At a session of the Court, held at Court of Appeals Hall in the City of Albany on the first day of April A.D. 1980

PRESENT, HON. LAWRENCE H. COOKE, *Chief Judge, presiding.*

Mo. No. 335

In the Matter of

the Application of New York Water Service Corporation,

Appellant,

for a Judgment &c.

vs

Public Service Commission of the State of New York,

Respondent.

A motion for leave to appeal to the Court of Appeals in the above cause having been heretofore made upon the part of the appellant herein and papers having been submitted thereon and due deliberation thereupon had, it is

ORDERED, that the said motion be and the same hereby is denied with twenty dollars costs and necessary reproduction disbursements.

/s/ JOSEPH W. BELLACOSA
Joseph W. Bellacosa
Clerk of the Court